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Tax Accounting for Prepaid Items

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COMMENTS

TAX ACCOUNTING FOR PREPAID ITEMS

Differences between tax accounting rules and generally accepted accounting principles have been a source of constant frustration to lawyers, accountants, and businessmen generally. Although the Regulations interpreting the Internal Revenue laws long asserted that, "approved standard methods of accounting will generally be regarded as clearly reflecting income,"[1] court decisions and Treasury rulings have undermined the broad principles enunciated in the Regulations. An especially troublesome problem for taxpayers has been the treatment of payments for expenses attributable to more than one year.[2] As a result of a recent decision, *Waldheim Realty & Inv. Co. v. Commissioner*,[3] presenting the problem again, the writer of this Comment seeks to analyze the permissible tax accounting methods,[4] with emphasis on prepaid expenses and, in particular, prepaid insurance premiums. Before investigating the effect of the foregoing case on certain of the "standard" accounting methods, it is necessary to consider the basic characteristics and requirements of each.

I. Accounting Methods

Two basic rules generally govern accounting for income tax purposes:

(1) The computation of net income is made for a fixed period of twelve months, commonly referred to as the taxable year.[5] It can never be for a longer period but there are some instances where the net income computation may be for a shorter period, as in the case of a taxpayer changing from the calendar year to a fiscal year.[6]

(2) The correct net income of the taxpayer must be reported in his return, and the taxpayer is required to maintain such account-

[1] U.S. Treas. Reg. 118, § 39.41-2(a) (1953). Similar language is embodied in the new Regulations. See U.S. Treas. Reg. § 1.446-1(a) (1957).

[2] See Note, 51 Harv. L. Rev. 716 (1938).

[3] 245 F.2d 823 (8th Cir. 1957).

[4] "Method of accounting" has been defined as "the way of keeping the taxpayer's records according to a defined and regular plan." Huntington Securities Corp. v. Busey, 112 F.2d 386 (6th Cir. 1940).

[5] Int. Rev. Code of 1954, § 441(b). This section provides: "Taxable Year.—For purposes of this subtitle, the term 'taxable year' means—

(1) the taxpayer's annual accounting period, if it is a calendar year or a fiscal year;
(2) the calendar year, if subsection (g) applies; or
(3) the period for which the return is made, if a return is made for a period of less than 12 months."

[6] Int. Rev. Code of 1954, § 443(a)-(1). This section provides: "A return for a period of less than 12 months shall be made . . . when the taxpayer, with the approval of the Secretary or his delegate, changes his annual accounting period . . . ."

ing records as will enable him to prepare a proper income tax return.[7] It has been generally held that informal records are not sufficient and that regular books of accounts are necessary.[8] However, books, though of evidentiary value, are not controlling in computing taxable income;[9] the determination of that sum depends upon the analysis of facts, not bookkeeping entries.[10] The Treasury has acknowledged that no one particular method of accounting can be required of all taxpayers,[11] and its Regulations indicate that any generally approved method[12] will, in most cases, clearly reflect income.[13] If the method used by the taxpayer for his general accounting also clearly reflects income for tax purposes, that method must be used in his annual return[14] and will also bind the Commissioner *if* the Commissioner or the courts believe that the method employed by the taxpayer does "clearly reflect the income."[15] But if no consistent method of accounting is used, or if the method used is held not to reflect the income clearly, it will be disapproved and the Commissioner has authority to compute the income according to a method which in his opinion does clearly reflect the income.[16] This is true even though the method has been consistently followed by the taxpayer for many years.[17] A secondary requirement in all Revenue Acts from 1918 up to the present date has been that the

[7] U.S. Treas. Reg. § 1.446-1(a)-4 (1957).

[8] Louis M. Brooks, 6 T.C. 504 (1946); Max H. Stryker, 36 B.T.A. 326 (1937).

[9] Deer Island Logging Co., 14 B.T.A. 1027 (1929); see Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918); In re Sheinman, 14 F.2d 323 (E.D. Pa. 1926).

[10] See Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918); Commissioner v. North Jersey Title Ins. Co., 79 F.2d 492 (3d Cir. 1935).

[11] U.S. Treas. Reg. § 1.446-1(a)-2 (1957): "It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited for his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year." This language is substantially the same as § 39.41-3 of Regulations 118, U.S. Treas. Reg. (1953).

[12] For purposes of this Comment methods of accounting will be limited to the five most commonly used accounting bases: the cash receipts and disbursements method, accrual method, hybrid methods, long-term contract methods and installment sales method.

[13] U.S. Treas. Reg. § 1.446-1(c) (1957); U.S. Treas. Reg. 118, § 39.41-2(a) (1953).

[14] Int. Rev. Code of 1954, § 446; U.S. Treas. Reg. § 1.446-1(a) (1957); U.S. Treas. Reg. 118, § 39.41-1 (1953); United States v. Mitchell, 271 U.S. 9 (1926); Shaw v. United States, 49 F.2d 628 (N.D. Ill. 1930). The Commissioner may not compute the taxpayer's income according to any other method. See Huntington Securities Corp. v. Busey, 112 F.2d 368 (6th Cir. 1940). Also, statements made in the return as regards the basis used on the books are not controlling, Aluminum Castings Co. v. Routzahn, 282 U.S. 92 (1930); Denman v. Squire, 111 F.2d 921 (6th Cir. 1940); Stern Bros. & Co., 16 T.C. 295 (1951).

[15] Lucas v. American Code Co., 280 U.S. 445 (1930). See also Julia Stow Lovejoy, 18 B.T.A. 1179 (1930).

[16] U.S. Treas. Reg. 118, § 39.41-1 (1953). U.S. Treas. Reg. § 1.446-1(b)-1 (1957).

[17] Heer-Andres Inv. Co., 17 T.C. 786 (1951); Robert G. Frame, 16 T.C. 600 (1951).

method used must have been regularly employed by the taxpayer.[18] The needs of any particular taxpayer admittedly will often require varying treatments of items within the overall accounting method,[19] but it is readily apparent that unlimited discretion on the part of the taxpayer would increase tax avoidance possibilities and render efficient tax administration impossible. Thus, although the selection of a particular accounting method is considered a matter to be determined by the taxpayer himself,[20] the method chosen must meet certain requirements; namely, it must be based on sufficient records; it must clearly reflect income; it must be regularly employed by the taxpayer; and its use must not cause excessive administrative inconvenience.

The following accounting methods are permissible under the Internal Revenue Code of 1954:[21]

(1) Cash receipts and disbursements method, commonly referred to as the cash basis;
(2) Accrual method;
(3) Hybrid methods;
(4) Any other method permitted under chapter 1 of the Internal Revenue Code of 1954.

The 1954 Code makes no fundamental changes in the definition of accounting methods which are acceptable for income tax purposes but several clarifying changes have been made. For the first time, the Code explicitly states that the taxpayer may, under appropriate circumstances, use hybrid methods of accounting and may treat certain items on the cash basis and other items on the accrual basis.[22] The Committee's report provides another minor clarification when it states that an individual taxpayer may maintain records and reports for tax purposes as regards his personal affairs by a method different from that used in his business.[23] Also, it is clearly stated that a taxpayer who is engaged in more than one business may

[18] Huntington Securities Corp. v. Busey, 112 F.2d 368 (6th Cir. 1940), reversing 26 F. Supp. 849 (S.D. Ohio 1939). See also Bancroft v. United States, 49 F. Supp. 476 (Ct. Cl. 1943). For a comprehensive discussion of the general rules regarding methods of accounting, see 2 Mertens, Federal Income Taxation § 12.05 (1955).

[19] U.S. Treas. Reg. § 1.446-1(a)-2 (1957); U.S. Treas. Reg. 118, § 39.41-3 (1953). See Squire v. Denman, 18 F. Supp. 287 (N.D. Ohio 1936), aff'd, 111 F.2d 921 (6th Cir. 1940); Schuman Carriage Co., 43 B.T.A. 880 (1941).

[20] Glenn v. Kentucky Color & Chemical Co., 186 F.2d 975 (6th Cir. 1951); Herndon v. Commissioner, 175 F.2d 55 (5th Cir. 1949); Ribbon Cliff Fruit Co., 12 B.T.A. 13 (1928).

[21] Int. Rev. Code of 1954, § 446(c).

[22] Int. Rev. Code of 1954, § 446(c)(4).

[23] See, e.g., Cecil v. Commissioner, 100 F.2d 896 (4th Cir. 1939); David Hanover, 12 T.C. 342 (1949).

use a different method for each;[24] however, this is still subject to the requirements discussed in the second paragraph, *supra.*

A. *Cash Receipts and Disbursements Method*

Under the cash receipts and disbursements method of tax accounting, items of gross income include the amount of cash and value of property actually received by the taxpayer or credited to his account or set apart for his use without restriction during the taxable year.[25] In the latter case the taxpayer is said to have received the item constructively.[26] Conversely, business deductions from gross income include the amount of cash and value of property disbursed, actually or constructively, for expenses allowed as deductions by the Code, plus items such as depreciation, depletion, amortization, etc. This method *must* be used when no books of account are maintained[27] or when the books are inadequate[28] but it may not be used when inventories are required.[29]

The cash method is only grudgingly recognized by the accounting profession[30] because it fails to allocate income and deductions to what is considered under general accounting principles to be the correct period, since it assumes that income is always earned when it is received and expenses are always incurred when paid.

B. *Accrual Method*

The taxpayer under an accrual method reports income in the taxable year in which the right to receive it becomes fixed,[31] even if received in a later year.[32] Thus, the *right* to receive income, rather than actual receipt, determines taxability. Conversely, the taxpayer deducts expenses in the taxable year in which the obligation to pay them becomes fixed[33] even though paid in a subsequent year. In addition, the taxpayer deducts for depreciation, depletion, amortization, etc. The accrual method is *mandatory* in all cases where it is necessary to use inventories in order clearly to reflect the taxpayer's

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[24] U.S. Treas. Reg. § 1.446-1(d) (1957).

[25] See Magill, Taxable Income 179-86 (rev. ed. 1945).

[26] For the rules relating to the doctrines of constructive receipt, see U.S. Treas. Reg. § 1.451-2 (1957). See also 2 Mertens, Federal Income Taxation § 10.01-10.18 (1955); Comment, Constructive Receipt: When Must the Taxpayer Pay?, 45 Ill. L. Rev. 77 (1950).

[27] Greengard v. Commissioner, 29 F.2d 502 (7th Cir. 1928).

[28] In re Newman, 94 F.2d 108 (6th Cir. 1938); Russell v. Commissioner, 45 F.2d 100 (1st Cir. 1930); Maurice Cross, 24 B.T.A. 1079 (1931).

[29] U.S. Treas. Reg. § 1.446-1(c)-2 (1957); U.S. Treas. Reg. 118, § 39.41-2(a) (1953).

[30] Shugerman, Accounting for Lawyers 150-151 (1952).

[31] U.S. Treas. Reg. § 1.446-1(c)(ii) (1957).

[32] Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934). For an excellent discussion of recognizing the taxable income under the accrual method, see Goldstone, Aspects of Recognition of Taxable Income upon the Accrual Basis, 12 Taxes 474 (1934).

[33] United States v. Anderson, 269 U.S. 422 (1926). See Magill, op. cit. supra note 25, at 193-216.

income.[34] When records are sufficiently complete to permit use of the accrual method, the courts are more likely to hold that a cash method whose use is challenged does not clearly reflect income.[35]

C. *Hybrid Methods*

A hybrid method of accounting combines the principles of several recognized methods of accounting, for example, the cash and accrual methods.[36] The Senate Finance Committee report[37] gave as an example a hybrid method of accounting for use by small retail stores, and the Regulations under the 1954 Code give this illustration:

> . . . a taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method in computing items affecting gross income from his trade or business.[38]

Prior to the enactment of the 1954 Code, a majority of the decisions which considered the matter held or implied that hybrid methods of accounting did not clearly reflect income,[39] but the 1954 Code expressly provides that hybrid methods of accounting are permissible,[40] although their use is still subject to the requirement that they clearly reflect income.[41]

D. *Other Methods*

1. *Long-Term Contract Methods*

Taxpayers engaged in heavy construction work encounter special accounting problems which differ from those in the ordinary com-

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[34]See note 29 supra.

[35] See, e.g., Caldwell v. Commissioner, 202 F.2d 112 (2d Cir. 1953); Becker v. United States, 21 F.2d 1003 (5th Cir. 1927); Leon Iron Co., 14 B.T.A. 830 (1928). The advantage underlying this tendency is that the accrual method provides for a closer matching of income and expenses incurred in earning such income. Therefore, it is more accurate than the cash method.

[36] Either all items of income are treated on one method and all items of expense on another, or only some items of income or expense are treated according to one method and some according to another.

[37] S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954). See also H.R. Rep. No. 1337, 83d Cong., 2d Sess. 158 (1954).

[38] U.S. Treas Reg. § 1.446-1(c)(iv)(a) (1957).

[39] Massachusetts Mut. Life Ins. Co. v. United States, 288 U.S. 269 (1933); United States v. Mitchell, 271 U.S. 9 (1926); Estate of Byrne, 16 T.C. 1234 (1951).

[40] Int. Rev. Code of 1954, § 446(c)(4). The Code itself does not refer to hybrid methods as such but permits "any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate." However, the legislative history of the section shows an intent to authorize hybrid methods. S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954).

[41] U.S. Treas. Reg. § 1.446-1(c)(iv) (1957). "In accordance with the following rules, any combination of the foregoing methods of accounting [referring to the accounting methods permitted by § 446(c)] will be permitted in connection with a trade or business *if such combination clearly reflects income and is consistently used.*" (Emphasis added.)

mercial businesses. Building, installation and construction projects require a considerable length of time to complete; frequently, unforeseen difficulties arise before the project is completed.[42] Such difficulties make it impossible for a construction contractor to determine whether he will make a profit or incur a loss on any particular contract until it is completed. Because of these problems, the 1954 Code[43] and the Regulations[44] allow taxpayers deriving income from long-term contracts[45] to use the cash or accrual methods[46] or one of two additional accounting methods. With the Commissioner's permission,[47] a taxpayer upon qualification may report either on the percentage of completion or on the completed contract method.[48]

Under the percentage of completion method the gross income to be reported for the taxable year is determined by applying to the total contract price the percentage that the cost of the work completed during the taxable year bears to the estimated cost of the total work necessary to complete the contract.[49] Expenditures made during the year on the contract are then deducted from gross income.[50] The use of this method requires the taxpayer to keep accurate separate records of the cost of work done on every contract during the year.[51]

Under the completed contract method the taxpayer reports no items of gross income or expenses until the taxable year in which the contract is "finally completed and accepted."[52] The taxpayer must maintain sufficient records to allow a computation according to this method. A distinct advantage to the taxpayer using the completed

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[42] E.g., losses and increased expenses due to strikes, price changes in materials used, work stoppages, bad weather conditions, penalties for delay, etc.

[43] Int. Rev. Code of 1954, § 446(c)(3).

[44] U.S. Treas. Reg. § 1.451-3 (1957); U.S. Treas. Reg. 118, § 39.42-4 (1953).

[45] "The term 'long-term contracts' means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted." U.S. Treas. Reg. § 1.451-3(a) (1957). This is the same language used in U.S. Treas. Reg. 118, § 39.42-4 (1953).

[46] G.C.M. 22682, 1941-1 Cum. Bull. 307.

[47] U.S. Treas. Reg. § 1.446-1(c)(1)(iii), 1.451-3(c) (1957). The taxpayer must elect to use these methods. See Don Berkemeier, 39 B.T.A. 1072 (1939); note 46, supra.

[48] U.S. Treas. Reg. § 1.451-3(b)(1, 2) (1957); U.S. Treas. Reg. 118, § 39.42-4(a)(1, 2) (1953).

[49] U.S. Treas. Reg. § 1.451-3(b)(1) (1957); U.S. Treas. Reg. 118, § 39.42-4(a)(1) (1953).

[50] Ibid.

[51] U.S. Treas. Reg. § 1.451-3(b)(1) (1957); U.S. Treas. Reg. 118, § 39.42-4(a) (1953); 2 Mertens, Federal Income Taxation § 12.130-12.133 (1955).

[52] U.S. Treas. Reg. § 1.451-3(b)(2) (1957); U.S. Treas. Reg. 118, § 39.42-4(a)(2) (1953); 2 Mertens, Federal Income Taxation § 12.134 (1955). For an excellent discussion of this method, see Note, Deferral of Income Under the Completed Contract Method of Tax Accounting, 64 Yale L.J. 448 (1955).

contract method is that income is reported only after all factors affecting profits are known. To this extent, this method is more accurate than the accrual method.

2. *Installment Method*

The installment method of accounting is permitted under the 1954 Code,[53] as under the 1939 Code,[54] if certain requirements are met.[55] Under this method the taxpayer includes as gross income that proportionate part of the installment payments actually received during the taxable year which the gross profit, realized or to be realized when the payments are completed, is of the total contract price.[56] Three types of income can be reported under the installment method of accounting:

(1) Dealers in personal property may report their income on the installment method;[57]

(2) The sale or other disposition of real property can be reported on the installment method *only* if there are no payments in the year of the transaction or if payments in that year do not exceed thirty per cent of the selling price exclusive of evidence of indebtedness of the purchaser;[58]

(3) A casual sale or other casual disposition of personal property, other than inventory, for a price exceeding $1,000 may also be reported on the installment method, provided however, there is no payment in the year of the transaction or if the payments in that year do not exceed thirty per cent of the selling price exclusive of evidence of indebtedness of the purchaser.[59] Here again, sufficient records must be maintained in order to make a computation under this method.

E. *Advances in the 1954 Code*

It is appropriate here to comment that the 1954 Code represents a definite advance in its effort to harmonize tax accounting and commercial accounting on various problems relating to the allocation of income and deductions to particular taxable years. Although the 1939 Code was substantially the same the new Code does set out definite accounting rules which will enable taxpayers to know

[53] Int. Rev. Code of 1954, § 453. Permissible also under § 446(c)(3). No regulations have been issued under the new Code.
[54] Int. Rev. Code of 1939, § 44, 53 Stat. 24.
[55] Int. Rev. Code of 1954, § 453. The Commissioner cannot require the use of this method unless the taxpayer has elected to use it. Max Viault, 36 B.T.A. 430 (1937).
[56] Int. Rev. Code of 1954, § 453.
[57] Int. Rev. Code of 1954, § 453(a).
[58] Int. Rev. Code of 1954, § 453(b).
[59] Ibid.

more accurately what methods of accounting are permissible and how to take advantage of the greater flexibility. Further, although no discussion was directed toward accounting for specific items of income and deductions, taxpayers have in many instances a choice of several methods. In most cases an election must be made in the first return. Bad debts, depreciation, research and experimental expenditures, returnable containers, and real property taxes are examples of specific items which may at the taxpayer's option be accounted for under any one of several accounting methods.[60]

II. EFFECTS OF THE WALDHEIM DECISION[61]

What effect does the *Waldheim* decision have upon the foregoing permissible accounting methods? In this case the taxpayer, a Missouri corporation engaged in owning and managing real estate, maintained its records and prepared its income tax returns on a cash receipts and disbursements basis. In the years 1950-1952 the taxpayer deducted the full amount of prepaid premiums for insurance on its properties, as it had done consistently since its incorporation in 1905.[62] The Commissioner disallowed the deductions and determined a deficiency, taking the position that prepaid insurance is a capital asset and its cost must be amortized or prorated over the life of the policy.[63] The Tax Court, using the *Boylston Market* case[64] as authority, upheld the Commissioner, saying that prepaid insurance is a capital asset because the unexpired insurance has a surrender value.[65] The Eighth Circuit decided otherwise and allowed the deductions, holding that prepaid insurance is not a capital asset and that premiums paid for insurance covering more than one year are properly deductible under section 23(a)[66] as a business expense for the year of payment.

Before considering background cases it is necessary to enumerate a few basic tax principles in this area. Business expenses are deductible if they are ordinary and necessary expenses paid or incurred

[60] For discussion of accounting methods for specific items, see Miller, Tax Problems in Change of Accounting Methods, 1957 So. Calif. Tax Inst. 353; Freter, Business Income, Expenses and Accounting Methods, 1955 U. Ill. L. Forum 357.

[61] 245 F.2d 823 (8th Cir. 1957).

[62] The fact that certain types of items have been expensed in prior years does not prevent the Commissioner, in a proper case, from requiring purchases of such items in later years to be capitalized. Hotel Kingkade, 12 T.C. 561 (1949), aff'd, 180 F.2d 310 (10th Cir. 1950). See also Polt v. Commissioner, 233 F.2d 893 (2nd Cir. 1956).

[63] The Commissioner took the position that the deduction must be claimed under section 23(L) of the Internal Revenue Code of 1939 (now Int. Rev. Code of 1954, § 167).

[64] Commissioner v. Boylston Market Ass'n, 131 F.2d 966 (1st Cir. 1942).

[65] 25 T.C. 1216 (1956).

[66] Int. Rev. Code of 1939, § 23(a)(1)(A), 53 Stat. 12 (now Int. Rev. Code of 1954, § 162(a)).

during the taxable year in carrying on a trade or business.[67] Certain capital expenditures such as amounts paid for machinery, new buildings and permanent improvements are not allowed as deductions,[68] but can be depreciated. Other capital expenditures can be deducted but the total amount of the deduction must be prorated over the useful life of the item.[69] The latter is in the nature of an expense while the former concerns the acquisition of income-producing assets. The theory behind this requirement of proration is that the useful life of such an "asset" extends beyond the taxable year. On the basis of these principles deductibility depends upon whether prepaid insurance is considered an amortizable capital expenditure or an ordinary and necessary business expense.

The question of accounting for prepaid insurance premiums became a distinct issue in *Higginbotham-Bailey-Logan Co. v. Commissioner*,[70] where the Board of Tax Appeals held that prepaid insurance premiums had to be allocated to each year covered. Advice was then sought as to whether taxpayers on the cash receipts and disbursements basis could deduct such prepaid insurance premiums as ordinary business expenses and the Bureau of Internal Revenue ruled that cash basis taxpayers must capitalize such payments.[71] This was the first time the Bureau recognized a direct analogy between prepaid insurance and prepaid rentals,[72] bonuses for acquisition of leases,[73] bonuses for cancellation of leases,[74] commis-

[67] See note 66 supra. See also U.S. Treas. Reg. 118, § 39.23(a)-1 (1954); U.S. Treas. Reg. § 1.162-1(a) (1957).

[68] Int. Rev. Code of 1954, § 263(a). A permanent improvement to a building is clearly a capital expenditure. Parkersburg Iron & Steel Co. v. Burnet, 48 F.2d 163 (4th Cir. 1931).

[69] Int. Rev. Code of 1939, §§ 23(L), (N), 113(a), (b), 114 (now Int. Rev. Code of 1954, §§ 167, 1011-12). See, e.g., E.H. Sheldon & Co. v. Commissioner, 214 F.2d 655 (6th Cir. 1954).

[70] 8 B.T.A. 566 (1927). (Taxpayer was on the accrual method of accounting). The Board stated: "The payment in advance of premiums for insurance results in the creation of an asset, since the policy has a surrender value. The asset value is exhausted ratably over the term for which the premium is paid. In the balance sheet such items are often carried under such terms as prepaid insurance, or prepaid expense."

[71] G.C.M. 13148, XIII-I Cum. Bull. 67 (1934). Robert H. Jackson, then General Counsel for the Bureau, stated: "The payment in advance of insurance premiums by a taxpayer rendering returns on the cash receipts and disbursements basis likewise results in the creation of an asset . . . . It is . . . the opinion of this office that where insurance premiums are deductible as business expenses and are paid in advance for a period of more than one year, only the pro rata part of such payments should be allowed as a deduction each year, regardless of whether the income is reported on the cash receipts and disbursements basis or on the accrual basis."

[72] Baton Coal Co. v. Commissioner, 51 F.2d 469 (3rd Cir.), cert. denied, 284 U.S. 674 (1931); Galatoire Bros. v. Lines, 23 F.2d 676 (5th Cir. 1928). See Main & McKinney Bldg. Co. v. Commissioner, 113 F.2d 81 (5th Cir.), cert. denied, 311 U.S. 688 (1940).

[73] Home Trust Co. v. Commissioner, 65 F.2d 532 (8th Cir. 1933); J. Alland & Bros., Inc. v. United States, 28 F.2d 792 (D. Mass. 1928).

[74] Steele-Wedeles Co. v. Commissioner, 30 B.T.A. 841 (1934); Borland v. Commissioner, 27 B.T.A. 538 (1933).

sions for negotiating leases,[75] and fees and commissions for securing a loan.[76] This same analogy was used later in the *Boylston Market* decision.[77]

The foregoing rule was short-lived when the same problem was considered on the appellate level in *Welch v. De Blois*,[78] where the First Circuit held that a taxpayer on the cash basis could in the year of payment deduct prepaid insurance premiums as ordinary and necessary business expense. The rationale of the *De Blois* decision was that a taxpayer may compute his income by the accounting method regularly employed by him so long as there is a clear reflection of income, and that a deduction of prepaid insurance premiums in the year paid by a cash basis taxpayer results in a clear reflection of income. The court denied that such payments created a capital asset.[79] This opinion was so persuasive to the Treasury officers that the Chief Counsel of the Bureau immediately issued an opinion accepting the decision and revoking the prior General Counsel's opinion.[80] Thus the practice of the Bureau was changed in accordance with the court's decision. The Tax Court, however, has refused to follow the *De Blois* decision in a few instances.[81]

In 1942 the First Circuit, in the case of *Commissioner v. Boylston Market Ass'n*,[82] expressly overruled the *De Blois* case and held that a taxpayer who keeps his books and prepares his income tax returns on the cash basis should deduct for each taxable year the pro rata portion of prepaid premiums applicable to that year. The court in the *Boylston Market* case reasoned that such insurance payments result in the creation of an asset, as the policy has a surrender value, and its cost can readily be prorated over the years of the policy. The analogy between such insurance payments and prepaid rentals, fees and commissions for securing a loan and bonuses and commissions for negotiating, acquiring or cancelling leases was used in finding an amortizable capital asset.[83]

[75] Bonwit Teller & Co. v. Commissioner, 53 F.2d 381 (2d Cir. 1931), cert. denied, 286 U.S. 690 (1932), 82 A.L.R. 325 (1933).

[76] Julia Stow Lovejoy, 18 B.T.A. 1179 (1930).

[77] 131 F.2d at 968.

[78] 94 F.2d 842 (1st Cir. 1938).

[79] 94 F.2d at 843. The court also placed great emphasis on a liberal construction of the statute (Section 41 of the 1939 Code).

[80] G.C.M. 20307, 1938-1 Cum. Bull. 157, revoking G.C.M. 13148, XIII-I Cum. Bull. 67 (1934).

[81] George S. Jephson, 37 B.T.A. 1117 (1938). For a subsequent case, see Frank Real Estate & Inv. Co., P-H 1939 T.C. Mem. Dec. 39499.

[82] See Annot., 144 A.L.R. 531 (1943); Note, 56 Harv. L. Rev. 818 (1943).

[83] The court stated: "Whether we consider these payments to be the cost of the exhaustible asset . . . or the cost of acquiring the asset . . . the payments are prorated pri-

The Bureau again changed its position and adopted the holding in the *Boylston Market* case.[84] Dean Griswold expressed his disapproval of the result reached in this case by pointing to the resulting confusion in the administration of the tax laws on a matter which ought to be kept clear, simple and uniform, maintaining that once the court had decided the question, and the Bureau had adapted its practice accordingly, any further changes in the law should come from the Congress or a higher court decision.[85] Numerous cases have followed the *Boylston Market* rule.[86]

In *Waldheim* the court refused to follow the First Circuit's decision in *Boylston Market* and elected to follow the overruled *De Blois* decision.[87] As a result, in the Eighth Circuit at least, prepaid insurance premiums are deductible in the year paid. The court found that Waldheim's income was clearly reflected when it accounted for such payments as ordinary and necessary business expenses and that such short-term insurance policies were not capital assets. In justification of its decision the court pointed out that since 1905 this cash basis taxpayer had always deducted prepaid insurance premiums in the year paid and that no *substantial* distortion of income resulted from its treatment of insurance deductions. With respect to the question of whether such insurance premiums are a capital asset, the cost of which must be amortized over its useful life, the court concluded that the premiums added nothing to the taxpayer's plant, equipment, or ability to earn income, and the fact that there is a possible salvage value upon surrender of the policy should not make the policy a capital asset. The court stated that although some salvage value can also be realized from miscellaneous supplies unused and on hand at the end of the taxable year, this fact alone does not warrant their treatment as capital assets.[88] The court also admitted that an inaccuracy can result from the deduction but said that a slight inaccuracy is preferable to changing the taxpayer's method when he has in good faith consistently used it. Thus we see that *some* distortion is allowed in reflecting income.[89]

marily because the life of the asset extends beyond the taxable year. To permit the taxpayer to take a full deduction in the year of payment would distort his income." 131 F.2d at 968.

[84] G.C.M. 23587, 1943 Cum. Bull 213, revoking G.C.M. 20307, 1938-1 Cum. Bull. 157, and reinstating G.C.M. 13148, XIII-I Cum. Bull. 67 (1934).

[85] See Note, 56 Harv. L. Rev. 818, 821 (1943).

[86] See, e.g., Bessie Cohen, P-H 1951 T.C. Mem. Dec. 51009; Boston Elevated Ry., 16 T.C. 1084 (1951); Martha R. Peters, 4 T.C. 1236 (1945).

[87] "We believe that the opinion in the De Blois case is more persuasive than the Boylston Market opinion." 245 F.2d at 828.

[88] 245 F.2d at 825.

[89] The court then computed the deductions for several years by each method and found

III. Conclusion

The accrual, hybrid, long-term contract and installment methods of accounting are unaffected by the *Waldheim* decision. But with regard to the cash receipts and disbursements method the *Waldheim* decision leaves two well-settled tax accounting principles in conflict, namely, that the taxpayer's accounting method must *clearly* reflect income, and that a taxpayer using the cash method of accounting is entitled to take ordinary and necessary business expenses as a deduction in the year paid. A consistent cash method sometimes misstates the taxpayer's income, but this disadvantage is at least partially offset by the method's convenience and simplicity.[90] This inaccuracy cannot, however, become too great or the basic requirement of a clear reflection of income will not be met. This seems to be the rule in the Eighth Circuit, at least.

The *Waldheim* decision definitely creates confusion in the administration of the income tax law, since the First Circuit continues to require the prepaid insurance deduction to be prorated over the useful life of the policies.[91] Although the Supreme Court grants certiorari to resolve conflicts between the circuits, it seems unlikely that the problem will be resolved in this manner. After the *Boylston Market* decision, Dean Griswold said:

> It is to be hoped . . . that the Supreme Court will soon have occasion to examine the question and establish a rule which will eliminate this matter of detail from further controversy.[92]

The *Waldheim* case represented an excellent opportunity for the conflict to be resolved by the Supreme Court but the government did not seek certiorari. However, it must be conceded that the Congress can better formulate technical tax accounting rules. Even though the present decision hampers efficient tax administration and leaves a conflict in the use of tax accounting methods, the case appears to be correct and is consistent with the theory of the cash receipts and disbursements method of tax accounting, namely, that both deductions and income should be reported in the year of cash payment or receipt.[93] Finally, the court's limitation, namely,

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that the difference was insignificant. "We do not believe that any substantial distortion of the taxpayer's income resulted from the method in which it handled its deductions for insurance expense." 245 F.2d at 828.

[90] See note 90 supra. See also Note, 51 Harv. L. Rev. 716 (1938).

[91] For a general discussion of the treatment of prepaid insurance premiums, see 2 Mertens, Federal Income Taxation § 12.26 (1955), § 12.26 (Supp. July 1957).

[92] Note, 56 Harv. L. Rev. 818, 821 (1943).

[93] North American Oil Cons. v. Burnet, 286 U.S. 417 (1932).

that this method should be disallowed only where its use results in substantial distortion of the taxpayer's income, is both reasonable and necessary.

B. J. Barton